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No. 06-1228

IN THE

Supreme Court of the United States

FIA CARD SERVICES, N.A., fka MBNA AMERICA BANK, N.A.,
Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

This Court has long recognized the importance of adhering to a single, "clear rule" to define the constitutional limits of state taxing power:

> Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."

Quill Corp. v. North Dakota, 504 U.S. 298, 315-16 (1992) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

Those considerations motivated the Court in *Quill* to grant certiorari and reaffirm the longstanding physical presence rule for state taxation in a case involving sales and use taxes. They warrant the same result in this income tax case.

Respondent does not and cannot deny that the physical presence rule is a "clear" rule, which "firmly establishes the boundaries" of state taxing power and "reduces litigation concerning" state taxes. Nor can respondent seriously deny that—largely due to aggressive overreading of dicta in *Quill* by state courts and state taxing authorities—the law has become a "quagmire," marked by "controversy and confusion," rather than the "precise" guidance previously afforded by uniform recognition of the traditional physical presence rule. Indeed, respondent itself concedes that "now 'there is room for debate over the question'" whether physical presence is required for the imposition of state income and franchise taxes. Opp. 7 n.4 (quoting J. Hellerstein & W. Hellerstein, *State and Local Taxation* 386 (8th ed. 2005)). A map recently published by a prominent accounting firm—attached

as an addendum hereto (and available at http://www.ey.com/Global/download.nsf/US/State_Economic_Nexus_Landscape/$file/EconomicNexusAlert_Map.pdf)—graphically illustrates just how broad and deep that "debate" has become.

It is time to end the discord on this critically important question. The boundaries of state taxing power should be clear and uniform, not obscure and debatable. As this Court reaffirmed in *Quill*, a state's power to collect sales and use taxes extends only to those businesses that establish a tangible, physical presence within the borders of the state—merely connecting with in-state customers through interstate commerce itself is not enough. Because there is no legitimate distinction for purposes of taxing jurisdiction between the taxes at issue in *Quill* and the income taxes at issue here, the longstanding, easily administrable physical presence rule must continue to apply here as well. Certiorari should be granted.

ARGUMENT

Respondent advances four grounds for denying certiorari: the physical presence rule is not supported by precedent; the conflict in the courts is insufficiently ripe; the existing burdens on interstate businesses are speculative; and the Court should await action by Congress. None of these arguments has merit.

A. Nothing In This Court's Precedents Supports Restriction Of The Physical Presence Rule To One Category Of State Taxation

Respondent contends that review should be denied because this Court's precedents endorse the physical presence rule only in the context of sales and use taxes, and that for all other taxes, a different, "more flexible" constitutional rule applies. Opp. 8. Respondent is wrong.

Respondent spends five pages (Opp. 6-11) arguing that this Court's precedents authorize the imposition of income and franchise taxes on entities with no physical presence in the taxing state. Remarkably, however, the entire discussion

does not cite a *single* precedent so holding. Instead respondent relies solely on *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), arguing that the four-part Commerce Clause test enunciated in that case "does not generally contain" a physical presence requirement. Opp. 8. But this Court already rejected that contention in *Quill*, where it held that *Complete Auto*'s threshold "substantial nexus" factor *does* require physical presence for the imposition of sales and use tax liabilities. 504 U.S. at 313-14.

Respondent predictably relies on *Quill*'s dictum observing that prior cases involving other types of taxes had not explicitly "articulated" a physical presence requirement (*id.* at 314), but respondent ignores *Quill*'s more important statement that prior cases *did*, in fact, "involve[] taxpayers who had a physical presence in the taxing State." *Id.* In other words, whether expressly articulated or implicitly understood, physical presence has *always* been a threshold requirement for the exercise of state taxing power, and no precedent of this Court has held or suggested otherwise.

Respondent also tries to glean a rejection of the physical presence rule from the general logic of *Complete Auto*. Respondent contends that it runs "counter to the substance-focused" *Complete Auto* test to allow a state to tax a small business with only a storefront presence inside the state, but not a large out-of-state business with no physical presence in the state but "millions of dollars of revenue attributable to" state residents. Opp. 9. This Court, however, rejected *precisely* that argument in *Quill*: "Like other bright-line tests," the Court explained, the physical presence rule may "appear[] artificial at its edges," because it may be triggered simply by a "small sales force, plant, or office," but any seeming "artificiality" is "more than offset by the benefits of a clear rule." 504 U.S. at 315. Those benefits, the Court emphasized, include giving clear guidance to state taxing authorities, "encourag[ing] settled expectations," and "foster[ing] investment by businesses and individuals." *Id.* at 316. Respondent does not even attempt to explain why

the same bright-line rule would not have the same salutory effects in the income and franchise tax context.[1]

Relatedly, respondent insists that physical presence is a "formalistic" rule, and *Complete Auto* rejected "formalism" in Commerce Clause analysis. Opp. 8. But, again, this Court rejected the identical argument in *Quill*, emphasizing that "not all formalism is alike." 504 U.S. at 314. The formalistic rule rejected in *Complete Auto* turned entirely on the *label* applied to certain state taxes, a purely semantic distinction which "served no purpose within . . . Commerce Clause jurisprudence." *Id.* "In contrast," the Court explained, the "bright-line," physical presence rule "furthers the ends of the dormant Commerce Clause," by "demarcat[ing] a discrete realm of commercial activity that is free from interstate taxation," thereby promoting settled expectations and investment, as noted above. *Id.* at 315.

Indeed, if anything, it is *respondent's* position that reflects an indefensible formalism. According to respondent—and to the courts that have adopted respondent's position—the constitutionality of a state tax on an out-of-state business turns on its nature as a sales or use tax, on the one hand, or an income or franchise tax, on the other. But for purposes of the Commerce Clause "nexus" requirement, there is simply no plausible distinction between the two categories of state taxation: a state either has the authority to collect taxes from an entity with no physical presence inside the state, or it does not. This Court's consistent holding that states lack such power as to sales and use taxes logically must encompass other forms of state taxation as well.

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[1] *Quill* likewise refutes respondent's assertion (Opp. 3, 9) that its taxation of petitioner is justified because it provides petitioner benefits in the form of the laws, courts, and services that facilitate the operation of a commercial market in the state. *See* 504 U.S. at 304 (rejecting argument that taxation is justified because state provided "legal infrastructure," "economic climate," and other indirect "services and benefits").

B. The Conflict Among State Courts Is Intolerable

Respondent next contends that review should be denied because the conflict among state courts is not adequately "ripe." Opp. 11. But as the attached map demonstrates, there can be no serious dispute that interstate businesses are currently subject to a bewildering array of conflicting nexus rules. Especially in light of this Court's repeated emphasis on the importance of clarity in the constitutional limits on state taxing power, *see supra* at 1, the need for certiorari could hardly be more stark.

Respondent's arguments to the contrary are meritless. Respondent does not deny that the decision below squarely conflicts with *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *aff'd*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), but instead misleadingly observes that the decision "is not a decision of the Tennessee Supreme Court." Opp. 12. What respondent ignores—even to the point of omitting subsequent history from its citation (*id.*)—is that the decision was, as a matter of Tennessee law, *effectively affirmed on its merits by the Tennessee Supreme Court*. Pet. 14.[2] Thus, the Tennessee Supreme Court has affirmed that a tangible physical presence is required to impose income and franchise taxes—a ruling in direct conflict with the decisions of the highest courts of West Virginia, New Jersey, and South Carolina. Pet. 15-17. That conflict is fully ripe for review.

The even broader division among lower state appellate courts (Pet. 13-17) only underscores the extent to which uncertainty prevails where clarity should reign. Respondent

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[2] Respondent's assertion that the unpublished decision in *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002), casts doubt on *J.C. Penney* (Opp. 12-13) is frivolous. The *America Online* court did not depart from the physical presence rule in any way, but rather *applied* the rule, remanding the case for a factual inquiry into whether contractors working inside the state for an out-of-state business established an in-state physical presence for the business. *Id.* at *3.

does not deny that the Michigan and Texas decisions requiring physical presence establish precedent binding statewide in those jurisdictions, but suggests they can be ignored because they are distinguishable on their facts. Opp. 13. Not so. Most significantly, respondent's effort to distinguish the Michigan precedents has been rejected by no less an authority than the Michigan Department of Revenue, which announced in the wake of the cases that it would adhere to the physical presence rule. Pet. 14-15 n.4. The constitutional rule in Michigan, in other words, is conclusively settled, and it conflicts squarely with the rule followed in West Virginia, New Jersey, South Carolina, and other states.

Respondent's effort to parse the Texas decision into oblivion—based on "circumstances" that "narrow" its holding requiring physical presence (Opp. 15)—is equally unavailing. The "circumstances" identified by respondent are simply the nature of the arguments advanced by the state to justify its tax, which had nothing to do with the unequivocal holding of the case:

> While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 300 (Tex. App. 2000). That holding governs all taxation in Texas—one of the largest commercial markets in the nation—and it is flatly irreconcilable with the decision below.

This conflict is ripe for review no matter how one looks at it. Interstate businesses are indisputably governed by different constitutional taxing rules in different states. Those rules are now firmly settled in many states. Other states

have more recently sought to enforce rules or statutes rejecting the physical presence rule, and—contrary to respondent's suggestion (Opp. 16-17)—there are numerous judicial challenges to those efforts.[3] And those costly challenges are simply exacerbating the burdens on interstate commerce. There is certainly nothing to be gained by awaiting some future case while allowing existing confusion and controversy to fester. The arguments have been fully vetted in reported appellate decisions. The burdensome effects of departing from a bright-line rule are empirically established and incontestable. *See infra* Part C. Further "percolation" will add nothing to the store of knowledge needed to determine whether the longstanding physical presence rule continues to apply to all state taxation, or is arbitrarily restricted only to sales and use taxes. This controversy should be settled now.

C. The Absence Of A Clear Rule Is Imposing Substantial Burdens On Interstate Commerce

Respondent's most startling contention is that interstate businesses are currently suffering "no burden" from the existing legal regime. Opp. 10, 16-17. Far from being "speculative" and "conjectural" (Opp. 10, 16), the burdens identified in the petition are real, concrete, and demonstrable—as confirmed by the seven amicus briefs filed in support of the petition on behalf of fourteen different business and tax organizations and their many thousands of members.

Those briefs make clear beyond any question that the current uncertainty over the scope of state taxation authority is interfering with strategic business planning, thwarting the expectations of businesses that have reasonably relied on the physical presence rule, and deterring new interstate investment by companies wary of incurring significant new tax liabilities, particularly small and medium-sized businesses

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[3] *See, e.g., Bridges v. Geoffrey, Inc.*, No. C 502,769, Section 24 (La. Ct. App.); *Capital One Bank v. Comm'r of Rev.*, Dkt. Nos. C262391, C262598 (Mass. App. Tax Bd.).

that cannot afford to bear such economic burdens. COST Br. 3-7, 16-18; ABA Br. 3-6; GPCC Br. 5-11, 14-17; TEI Br. 14-16; DMA Br. 7-11, 14-15. It is making compliance with financial reporting requirements difficult (ABA Br. 6-12; COST Br. 18-19; TEI Br. 16-17) and threatening to impede foreign commerce (CHA Br. 4-17). And it is subjecting businesses to the exorbitant compliance costs associated with filing business and franchise tax returns in multiple jurisdictions—a burden that will only intensify if more taxing jurisdictions are permitted to impose taxes on businesses based merely on the presence of customers in the jurisdiction. COST Br. 7-16; Tax Foundation Br. 5-9.

This overwhelming showing by amici exposes the absurdity in respondent's suggestion that nobody knows whether income taxes "are actually being applied to businesses that lack a 'physical presence.'" Opp. 16. Of course they are—reaching interstate businesses with no physical presence is the *entire point* of the quickly expanding efforts by states to adopt laws supplanting the physical presence rule with loose and varied "economic nexus" approaches. Pet. 17; COST Br. 5 & n.2. Petitioner and amici can attest directly to the fact of such widespread taxation and to its enormously costly effects on interstate business operations.

This Court in *Quill* noted similar adverse economic consequences from imposing sales and use tax collection obligations on sellers that lack an in-state physical presence. *See* 504 U.S. at 313 n.6. The costs of imposing income and franchise taxes in the same situation are vastly higher. Respondent contends otherwise, but its only support is a lengthy block quote from the decision below asserting that sales and use tax obligations are more onerous simply because they "must be remitted to the government on a more frequent basis than income and franchise taxes." Opp. 10 n.5 (quoting Pet. App. 16a-17a). Nonsense. As detailed by amicus COST in particular, for interstate businesses, complying with income and franchise tax requirements across thousands of jurisdictions requires many thousands of personnel hours de-

voted entirely to deciphering countless state and local tax requirements and exercising the judgments necessary to ensure compliance with all jurisdictions' laws. COST Br. 7-16. In fact, this Court itself has already recognized that the "duty to collect a use tax" imposes a *smaller* burden on interstate businesses than a "direct tax upon . . . gross receipts." *Nat'l Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 557-58 (1977). If the burdens of sales and use tax collection on out-of-state businesses justified review and reversal of the state court's decision to reject the physical presence test in *Quill*, the exponentially greater burdens imposed by income and franchise taxation compel the same result here *a fortiori*.

These burdens certainly are not eliminated by the other three *Complete Auto* requirements, as respondent asserts. Opp. 17. Again, if that were true here, it would have been true in *Quill*, yet the *Quill* Court reaffirmed physical presence as essential to satisfying the nexus prong of *Complete Auto*. As *Quill* indicates, even if the other three *Complete Auto* criteria—fair apportionment, non-discrimination, and fair relationship to state services—were perfectly administered, the mere task of determining where to pay taxes and how much to pay becomes staggeringly complicated when a company cannot rely on its physical locations as the jurisdictional anchor for determining tax obligations.

Perhaps even more important, however, is the fact that the other *Complete Auto* criteria are *never* perfectly administered. In particular, this Court explicitly recognized in *National Geographic*, 430 U.S. at 557, that the apportionment prong is *always* imperfect, and that suffering some degree of multiple taxation is therefore an inevitable consequence of doing business in multiple jurisdictions. But the Court also recognized in *National Geographic* that multiple taxation is a "vice," to be tolerated when necessary, and avoided when possible. *Id.* It is beyond dispute that exposing interstate business to the taxing power of more than 8,000 state and local jurisdictions will dramatically exacerbate the multiple

taxation that is inherent in interstate taxation. Nothing in the apportionment prong of *Complete Auto* can alleviate the manifest unfairness of that result.

D. The Court Should Not Await Action By Congress

Finally, respondent argues that review of the question presented here is "premature" because Congress might some day adopt a statutory alternative to the physical presence rule. Opp. 19. This Court, however, routinely grants certiorari to review questions that could, in theory, be addressed by Congress—including every federal statutory case this Court has ever decided. The purely hypothetical prospect of congressional action has never posed a barrier to certiorari. To be sure, some immediately imminent congressional solution might caution against this Court's intervention into a controversy, but there is no such action on the horizon here.

In fact, if anything, the hypothetical prospect of congressional action affirmatively supports certiorari in this case. As explained in the petition, so long as enforcement of Commerce Clause boundaries on state taxation remains the province of the judiciary, there is only one "nexus" rule courts can administer fairly: the long-familiar physical presence rule. Pet. 28-30. If there is to be a *departure* from that rule, Congress is the body authorized by the Constitution to specify the relevant standards, exceptions, safe harbors, and so forth. *Id.* at 30. Thus, if the Court reaffirms the existing physical presence rule for income and franchise taxation, and West Virginia and other states continue to object to that rule, they can ask their representatives in Congress to adopt a more reticulated statutory approach. But in the absence of congressional action, the uniform default rule should remain what it has always been: the clear, understandable, and judicially manageable physical presence rule.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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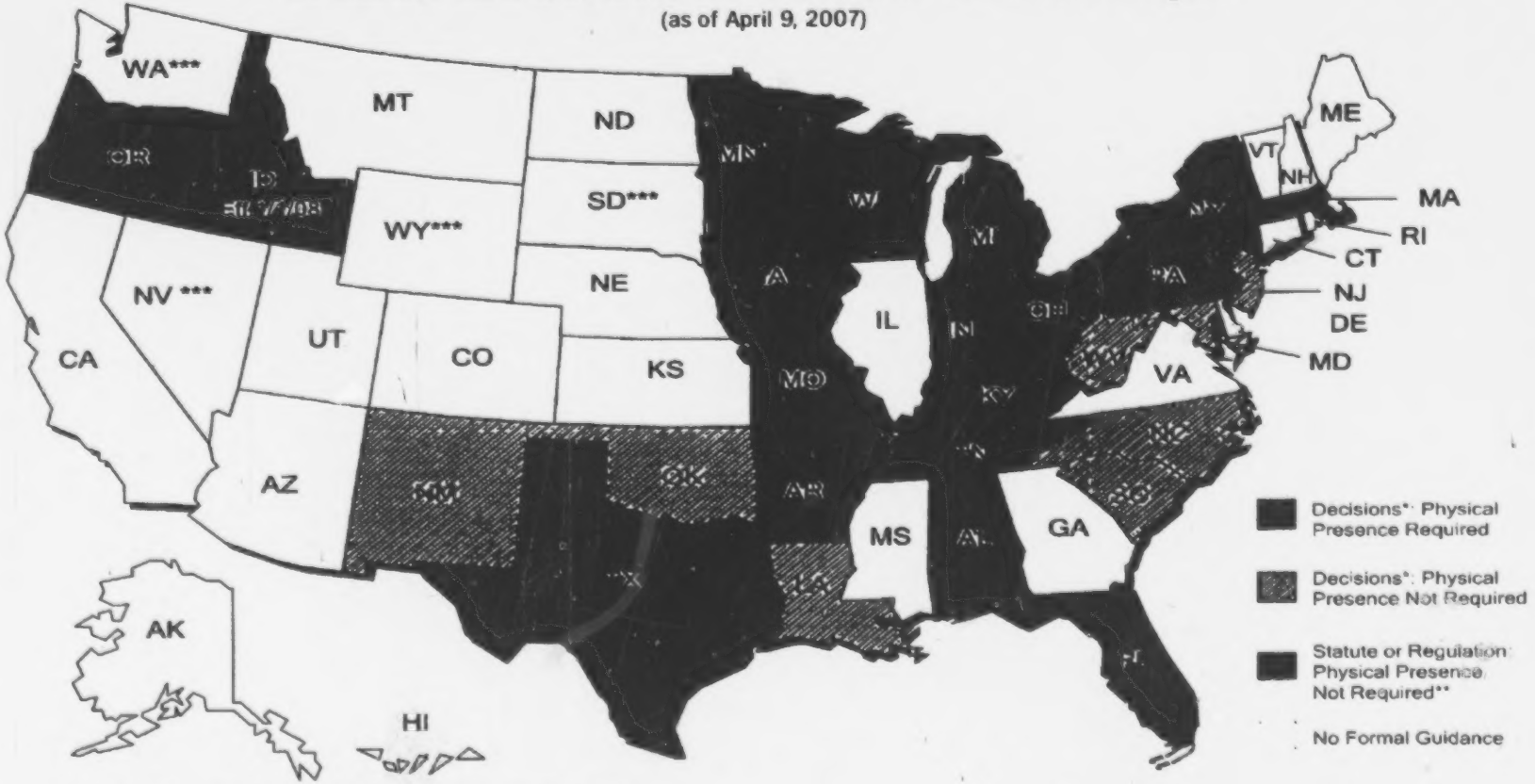
ADDENDUM

BEST AVAILABLE COPY

State Economic Nexus Landscape

(as of April 9, 2007)



* "Decisions" include administrative and judicial level decisions

** States fall within this category if the state adopts an economic-presence standard for any state business activity tax (franchise, income, gross receipts)

*** States with no general corporate income tax

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